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In the
Supreme Court of the United States
October Term, 1968

No. 140

GOOD-ALL ELECTRIC MFG. CO.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

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The petition for certiorari challenges the holding that petitioner accumulated its earnings and profits beyond the reasonable needs of the business on these grounds:

1. Failure of the lower courts to determine what earnings and profits were accumulated.
2. Failure of the lower courts to determine what were the reasonable needs of the business.

3. The disregard of renegotiation and tax liabilities which, if considered, eliminated any possibility of accumulation beyond the reasonable needs of the business.

Respondent apparently concedes the absence of any finding as to earnings and profits. He defends on the ground that the proper inquiry is not what were the earnings and profits but "* * * what the corporate managers thought the income was * * *." (Opp. 4).

Whatever validity this argument might have in another case, it has absolutely none in the case at bar. The imposition of the accumulated earnings tax was based entirely upon the Commissioner's purported determination and contention that petitioner's earnings and profits were accumulated beyond the reasonable needs of the business. The notice of deficiency (Ex. A of Pet. in Tax Court) asserted:

> "It is determined that the corporation was availed of for the purpose of preventing the imposition of surtax upon its shareholders * * * through the medium of permitting its earnings or profits for the taxable years * * * to accumulate beyond the reasonable needs of its business * * *."

Respondent's contention, as stated by the Tax Court, was:

> "Respondent contends that the earnings and profits of the corporation were permitted to accumulate beyond the reasonable needs of the business during each of these years." (Pet. 73)

The Tax Court, after purporting to find that the earn-

ings and profits were accumulated beyond the reasonable needs of the business, asserted:

> "Under section 102 (c) of the 1939 Internal Revenue Code a finding that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of its business is deemed determinative of the purpose to avoid surtax upon its shareholders, * * * unless the corporation proves to the contrary by a clear preponderance of the evidence. * * * We hold that the corporation has not met its burden of proof in this respect." (Pet. 78, 79)

In view of the foregoing, the Court of Appeals based its decision on the assumption "that there can be no section 102 surtax unless earnings and profits were accumulated beyond the reasonable needs of the business." (Pet 43).

A valid decision required a finding as to what earnings and profits were accumulated and a comparison of these earnings and profits with the reasonable needs of the business. Respondent's present argument would seem to be a clear acknowledgment that this essential finding was not made. It should also be noted that respondent does not attempt to justify the failure of the lower courts to determine whether liabilities owed to the federal government for renegotiation and additional taxes reduces income in determining earnings and profits.

The lower courts also failed to make a finding as to the other essential fact, the reasonable needs of the business. Respondent seems to argue that no such finding is necessary, that petitioner had the burden of proof on this

issue and that petitioner failed in this burden (Opp. 5). These contentions are absolutely erroneous.

In the first place, both the Tax Court and the Court of Appeals made their decisions on the basis that the burden of proof on this issue was on the respondent because of the statement filed by petitioner under Section 534 (c) of the Internal Revenue Code of 1954 and the provisions of Section 534 (a) of that Code (Pet. 74, 75. 43). Moreover, voluminous evidence on this issue was introduced by both parties and, under these circumstances, any presumption disappears and the decision must be based on the evidence. *Robert Louis Stevenson Apartments, Inc. v. Commissioner of Internal Revenue,* 337 F. 2d 681, C. A. 8, 1964, and cases cited therein. The Tax Court is, therefore, required to make a finding on the issue. I. R. C. 1954, Section 7459 (b).

In addition, on page 7 of the petition, we set forth the actual earnings and profits of the petitioner under the Tax Court's own decision and a listing of only those business needs which are undisputed as to amount and validity. Those figures demonstrate the absence of any accumulation beyond the reasonable needs of the business.

The only issue respondent takes with those figures is that line 2 at the top of page 7 includes the accumulated earnings tax imposed by the Tax Court and that, for purposes of determining whether profits were accumulated beyond the reasonable needs of the business, this tax should be eliminated. But even if we make this ad-

justment and eliminate this tax not only for each current year but for all prior years, the result does not change.

Thus, if we take the actual earnings and profits under the Tax Court's decision (line 6 at top of page 7 of the petition), increase those earnings by the amount of the accumulated earnings tax under the Tax Court's decision, and compare this adjusted figure with the business needs reflected in line 13 at the bottom of page 7 of the petition, the result is as follows:

	1950	1951	1952	1953	1954
Line 6	$146,083.86	$115,337.72	$138,427.55	$ 116,034.24	$ 437,832.90
Sec. 102 Tax per Tax Court	88,770.39	125,689.36	121,734.63	218,207.08	289,676.65
Adjusted earnings and profits	$234,854.25	$241,027.08	$260,162.18	$ 334,241.32	$ 727,509.55
Capital needs (Line 13)	$ (342,504)	$321,273	$787,201	$1,314,197	$3,347,545

Just as in the table on page 7 of the petition, the undisputed capital needs substantially exceed accumulated earnings and profits (adjusted in accordance with respondent's contention) in every year except 1950.

Respondent's contentions as to the other issues are adequately covered in the petition.

Respondent has, however, made certain statements that need correction. Thus, in footnote 5 on page 4 of the memorandum in opposition, respondent asserts that petitioner claims a deduction under Section 102 (d) (1) (A) of the Internal Revenue Code of 1939 for the tax shown on the original return and that this would permit a "double deduction". As set out in the petition, our contention is that the deduction is the actual tax liability but that, if

this is not correct, "the only reasonable alternative is the amount of tax shown on the tax returns." (Pet. p. 20).

The "double deduction" referred to is the amount by which the tax shown on the original return exceeds the actual tax liability. But petitioner claims a deduction for the actual liability. Respondent, on the other hand, wants to allow a deduction for only a part of this liability. He makes adjustments for items that reduce the deduction, such as renegotiation, but refuses to make adjustments for items that would increase the deduction. This, we submit, is illogical, unjust and contrary to law.

In footnote 7 on page 5 of the memorandum in opposition, respondent states that the total accumulated earnings of petitioner over the five-year period were $2,528,642.29. As shown on page 7 of the petition, the total accumulated earnings under the Tax Court's own decision were only $953,716.27. If we assume that the accumulated earnings tax does not apply in any year, the earnings and profits for this entire five-year period would be only $1,797,794.38.

At page 6 of the memorandum in opposition, respondent implies that petitioner claimed a right to deduct the accumulated earnings tax under Section 102 (d) (1) (A) of the Internal Revenue Code of 1939. No such contention was ever made. Petitioner does contend that it is entitled to deduct the full amount of its income and excess profits taxes, not just a portion thereof.

Respondent has not seen fit to comment on his own rulings (I. T. 3688, C. B. 1944, page 401, and Revenue Ruling 57-332, C. B. 1957-2, page 231) holding that re-

negotiation and federal income tax liabilities reduce earnings and profits for the years to which the liabilities apply and his further holding in Revenue Ruling 57-332 that additional tax liabilities reduce earnings and profits in the year incurred, notwithstanding the fact that the liability is contested and finally determined only in some later year.

Respectfully submitted,

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August, 1968.